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Neoliberalism and the global financial crisis

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Abstract:

The new right advocated policies that aided the accumulation of profits and wealth in fewer hands with the argument that it would promote investment, thereby creating more jobs and more prosperity for all. However financial markets provide opportunities for investment without creating jobs and, as the global financial crisis has revealed, speculative investment feeds an ephemeral prosperity that can be wiped out in a short time period. Inequities resulting from new right policies – including the deregulation of labour markets and the reduction of government spending – reduced consumer demand which had to be propped up with consumer credit and mortgage debt. Financial deregulation, also promoted by the new right, enabled financial institutions to dictate government policy and enabled wealth to be channelled into speculative investments exacerbating the volatility of share and housing markets. The combination of household debt and unregulated speculative investment led to the collapse of the subprime mortgage market followed by the bankruptcy of major financial institutions and the collapse of share markets around the world. Yet the Rudd government continues to place its faith in markets as a way out of the crisis.

Key words: neoliberalism, financial markets, equity, deregulation

Neoliberalism and the global financial crisis

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The new right promoted a fundamentalist view of markets that came to be referred to as economic rationalism in Australia and, more widely, as neoliberalism. It advocated the replacement of government functions and services with those provided by private profit-seeking firms operating in the market (privatization); deregulation of labour and financial markets; deregulation of business activities; free trade; and smaller government through reduced taxes, spending and regulation. These policies were promoted in the name of free markets, economic growth and the public interest (Beder 2006b, ch.4).

The new right argued that competition and unrestrained selfishness was of benefit to the whole society in capitalist societies (Sheil 2000, 26). It asserted that as a nation gets wealthier the wealth will 'trickle down' to the poor because it is invested and spent thereby creating jobs and prosperity. In fact the global financial crisis has shown that financial markets provide opportunities for investment that provide relatively few extra jobs and that feed an ephemeral prosperity that can be wiped out in days.

Neoliberal theories were embraced by big business because they provided a legitimation for their pursuit of self-interest and avenues for business expansion (Beder 2006a, 151). They supported the argument that government regulation interfered with business and undermined 'enterprise culture' (Self 1993, 72). In this view government intervention in the management of the economy is unnecessary and unwise because the Market is a self-correcting mechanism. There was also some appeal in free market ideology for governments too in that it absolved them of responsibility for economic performance (Beder 2006a, 8).

OUTCOMES AND INEQUITIES

As neoliberal policies were implemented around the world disparities in wealth and income increased and poverty increased, contradicting neoliberal theories that by increasing the wealth at the top everyone would be better off.

In Australia economic rationalism – adopted by the Hawke/Keating governments in the 1980s and continued by the Howard government in the 1990s – resulted in efforts to reduce government deficits, reduced taxation for high income earners, deregulation of financial institutions, floating of the dollar, reduction in tariffs and import restrictions, privatisation, and business deregulation (Garnaut 1994, 53-4). These reforms – termed 'restructuring' – were supposed to enhance economic efficiency, productivity and industrial competitiveness (Beder 2006b, 65).

The reinvigoration of the Australian manufacturing sector that was supposed to result from this 'economic restructuring' never occurred. The extra money generated in the 1980s by lower corporate taxes, higher profits and deregulation was seldom reinvested

in productivity. Rather it was squandered on 'increased executive salaries, increased luxury consumption and a mass of unproductive investment, seeking wealth through shuffling paper, takeover bids and counter-bids' (McEachern 1991, 80). The Australian ideal of egalitarianism was destroyed as wealth disparties in Australia began to rival and exceed other countries (Thompson 1992, 16).

The same policy prescriptions, referred to as the Washington Consensus, were forced on developing nations at an international level through the use of loan conditions and structural adjustment packages by the World Bank and the IMF. The Washington Consensus benefited transnational corporations and large companies, often at the expense of small local businesses, and always at the expense of the poor (Beder 2006b, 46). It gave economic goals priority over social goals, destroying socially beneficial traditions and desirable aspects of cultures in the process (Stilwell 1993, 36). Progressive taxation systems were dismantled and government social services decimated. The aim was for governments to be responsible for little more than law and order and national defence (Williamson 1994, 17).

Nations following IMF prescriptions did not prosper: 'the majority of those nations that have followed the IMF's advice have experienced profound economic crises: low or even declining growth, much larger foreign debts and the stagnation that perpetuates systemic poverty.' Some countries that had declined the IMF's 'enhanced structural adjustment' loans were in contrast better off (Kolko 1998, 21).

In the two decades before the introduction of the Washington Consensus government, spending and welfare schemes were looked on with approval and the income (as measured by mean GDP per capita) grew by 73 percent in Latin America and 34 percent in Africa. In the following two decades, as the Washington Consensus was applied to most nations in Africa and Latin America, incomes in Africa declined by 23 percent and the Latin American economies only grew by 6 percent (Palast 2002, 48).

The gap between rich and poor has increased. Forty four percent of people in developing nations live in poverty and unemployment doubled in the last decade of the 20th Century (Blustein 2002, E01, Lapper 2002, 1, Forero 2002, A-1). Even the IMF admits that 'in recent decades, nearly one-fifth of the world population have regressed' (IMF *World Economic Outlook* report quoted in Palast 2002, 50).

In the US '[t]hree decades of neoliberal economic policy has led to widest gap between rich and poor in America as compared to other industrialized nations…Currently the top 20% of population in America receive about 50% of income, while the lowest 20% get merely 3.4% of the income, and the top 1% own 40% of the wealth.' (Torbat 2008) Although average wages increased by 2.5 percent between 2000 and 2007 this increase actually occurred at the top of the wage hierarchy with Wall Street traders and executives earning a billion dollars between 2003 and 2007 (Muzaffar 2008), while the real wage of the median household fell over that time (Sapir 2008).

Such disparities in income have been accepted because greed has been institutionalised and legitimised as a driver of free market economies: 'The rapacious acquisition and accumulation of wealth by an elite is sanctified as a vital pre-requisite for the progress and prosperity of the people. The poor, it is argued, will eventually benefit from the wealth created by the elite.' (Muzaffar 2008)

FINANCIAL MARKET COERCION

Whilst the IMF and the World Bank enforced the Washington Consensus on poorer countries in desperate need of capital, other more affluent countries were forced into adopting the same formula by the world's financial markets. Their vulnerability to these markets was facilitated by financial deregulation.

Financial deregulation involved three actions: the opening up of a nation to the free flow of capital in and out of it; the removal of regulations on financial institutions operating within a country; and the removal of political controls from the central bank (Patnaik 1999). In this way the financial sector of a nation becomes part of the international financial sector rather than a part of the domestic economy and it serves the interests of global financial institutions rather than the interests of the local people or national governments (Beder 2006b, 47-52).

Financial deregulation was demanded by business interests, particularly large financial firms and transnational corporations that wanted to be free to move their money around. The economic argument for financial deregulation, supplied by free market think tanks and economic advisors, was that the free and unregulated movement of capital is more efficient, because capital can move to where it gets the best returns (Helleiner 1996, 194, Bell 1997, 103-4).

As a result of financial deregulation governments become accountable to international financial markets. According to Professor of Economics, Prabhat Patnaik (1999):

> An economy exposed to the free flow of international finance capital, however, is obsessed with the need to appease international financiers, to retain their 'confidence': the thrust of policies in such an economy therefore, even in principle, is not towards serving the interests of the people but towards serving the interests of the speculators, which represents *an inversion of democracy*.

Similarly, the Economics Editor of the *Financial Times*, Peter Norman (Norman 1994), observed:

> Because they process the many billions of dollars worth of investments flowing across national borders each day, the markets have become the police, judge and jury of the world economy—a worrying thought given that they tend to view events and policies through the distorting lenses of fear and greed.

The judgement of financial markets is neither wise nor well thought out. Rather it is panic-driven and herd-like. Decisions to buy and sell are not made on the basis of what is good for a nation's economy but rather on the basis of trying to second guess other investors. This merely serves to create economic instability and does little to foster productive long-term investment. Investment capital that could otherwise be used in production is used for gambling on the economies of various countries. Professor Walden Bello (Bello 2008) notes:

> The problem with investing in financial sector operations is that it is tantamount to squeezing value out of already created value. It may create profit, yes, but it does not create new value... Because profit is not based on value that is created, investment operations become very volatile and prices of stocks, bonds, and other forms of investment can depart very radically from their real value.

Financial deregulation exposes 'the economy to the vortex of speculative capital movements, that is, to the flows of short-term finance in search of quick profits.' For example, only ten percent of transactions in currency markets represent actual trade. The rest is largely speculative (Patnaik 1999, Toussaint 1998, 52). The rapid inflow and outflow of speculative finance can cause crises in national economies (Patnaik 1999). David Korten (quoted in Barlow and Clarke 2002, 93), once a senior advisor to USAID, says of these speculators:

> Each day, they move more than two trillion dollars around the world in search of quick profits and safe havens, sending exchange rates and stock markets into wild gyrations wholly unrelated to any underlying economic reality. With abandon they make and break national economies, buy and sell corporations and hold politicians hostage to their interests.

Thomas Friedman (Friedman 1999, 90-91) uses the term the 'Electronic Herd' to refer to 'the faceless stock, bond and currency traders sitting behind computer screens all over the globe, moving their money around with the click of a mouse from mutual funds to pension funds to emerging market funds' and the 'big multinational corporations who now spread their factories around the world, constantly shifting them to the most efficient, low cost producers'. It is they who have become the final arbiters of 'good' government policy.

Countries can still retain a veneer of democracy with choice between major parties, but because of the constraints imposed by the need to please international financial markets, the policy differences between the major parties is minimal. They all adopt the same free market policies (Patnaik 1999). Governments that try to deviate are punished by the markets, in particular, 'the major international banks, large transnational corporations with major financial dealing, fund managers within key private financial institutions, and the key credit-ratings agencies (such as Moody's)' (Bell 1997, 105).

INEQUALITY AND DEBT

Inequities in income in many countries, resulting from neoliberal policies, meant that consumer demand could not keep up with production capacity. Consequently profits from investing in production declined and economic growth slowed. Once governments would have fed demand through government spending, but neoliberalism precluded this. Instead consumer demand was increased through bank credit to consumers (Torbat 2008). This temporarily ensured continued economic growth in many countries. In the US, cuts in interest rates ensured more borrowing in order to sustain economic growth (Gupta 2008).

Consumer credit was augmented by mortgage debt. The middle-classes in the US, for example, borrowed money through home mortgages, to pay for consumer items and to be able to invest in the booming stockmarket (Sapir 2008). More and more people were given these loans despite declining wages, because rising house prices seemed to guarantee that the loan institutions could not lose. If people defaulted on their mortgages the repossession of their homes would cover their debt. 'By 2004, Americans were using home equity to finance as much $310 billion a year in personal consumption.' (Gupta 2008) By 2008 household debt was up to 93 percent of US GDP (Sapir 2008), and was a key driver of economic growth in the US (Gupta 2008).

Low interest rates meant more home buyers could afford to buy homes and more of them could afford more expensive homes so that house prices went up. 'Big ticket mortgages were aggressively sold to millions who could not normally afford them by offering low "teaser" interest rates that would later be readjusted to jack up payments from the new homeowners.' (Bello 2008)

The demand for housing as an investment, caused house prices to increase even more. This demand increased after the stock market declines in 2000 and 2001 when nervous investors moved from the stock market to property as a safer investment (Gupta 2008).

CONSEQUENCES OF FINANCIAL DEREGULATION

As we have seen, as a result of neoliberal policies, wealth accumulated in the hands of the few who searched for ways to invest it that were more profitable than investment in production. The financial sector offered lucrative investment opportunities, exacerbating the volatility of markets that accompanies 'massive speculation' (Muzaffar 2008).

The neoliberal opposition to government intervention in business and markets, and in particular the deregulation of financial institutions, allowed financial markets to become more and more complex as traders worked out more and more ways to make money from both rising and falling markets, using derivatives, credit default swaps, and other mechanisms that were often beyond the understanding of the layperson and many politicians (Bello 2008).

> …everyone acknowledges by now that Wall Street's capacity to innovate and turn out more and more sophisticated financial instruments had run far ahead of government's regulatory capability, not because government was not capable of regulating but because the dominant neoliberal, laissez-faire attitude prevented government from devising effective mechanisms with which to regulate (Bello 2008).

One investment mechanism was 'collateralized debt obligations' (CDO's), which turned home mortgages into a tradeable commodity. Banks could earn fees from setting up mortgages and then sell on the mortgage so as to free up their money to establish more mortgages. Once the mortgage was sold on, the bank did not have to worry about whether the mortgage would be paid off and so it was less concerned about ability to pay when it approved loans. 'Banks began using call centers and high-pressure tactics

to mass-produce mortgages because the profit was in volume—how many loans could be approved how fast.' (Gupta 2008)

To make these mortgages attractive to investors, the banks had them assured by Fannie Mae or Freddie Mac, which to investors was as good as a government guarantee for the mortgages since they were sure the US government would not allow these institutions to go bankrupt. Fannie Mae, Freddie Mac, banks and hedge funds bundled mortgages together as mortgage-backed securities (MBS) to sell them to investors who would then own the right to receive mortgage payments (Gupta 2008).

MBSs were further bundled with other investment products into CDO's. The various middle-people who were involved in selling them on had an interest in understating the risks associated with these CDOs and because financial markets had been deregulated they were free to do so. Banks and foreign financial institutions were ready to believe assurances of low risk because they assumed house prices would continue to rise indefinitely (Bello 2008, Gupta 2008).

However, rising house prices led to a building boom and an oversupply of housing, contributing to the bursting of the housing price bubble. Oversupply was exacerbated when interest rates were increased and hundreds of thousands of people could no longer afford their mortgage payments and their houses came back onto the market (Gupta 2008). When this happened the owners of the MBSs and CDOs found that the houses were now worth much less than the mortgages they had bought and for companies like Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac and Bear Stearns, their consequent losses were more than they could afford and they were threatened with bankruptcy (Bello 2008).

Other companies such as the American International Group (AIG) lost money on credit default swaps – 'derivatives that make it possible for investors to bet on the possibility that companies will default on repaying loans. Such bets on credit defaults now make up a $45 trillion market that is entirely unregulated.' (Bello 2008)

Financial institutions around the world were exposed to these CDOs and suffered major losses; some having to be bailed out by governments. The collapse and near collapse of major financial institutions led to a series of panics in stock markets around the world, wiping trillions of dollars off the value of stock. Falling share prices, combined with the unavailability of credit as banks became more cautious, caused a decline in business and consumer confidence as well as a slump in consumer demand and lowered economic growth, which have in turn fed rising levels of unemployment and recession.

The response of governments around the world has been aimed at stimulating their economies. In Australia although Kevin Rudd has argued for more international financial regulation his economic policies continue to be largely based on faith in markets. While the Rudd government stimulus packages include some proposed infrastructure investment they rely too heavily on providing consumers with spending money in the vain hope that the market will ensure that people spend it in ways that will stimulate the economy.

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